Member choice, to complement small pots' consolidation, culminating in a single pot for life

BRIEFING NOTE

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SMF Social Market Foundation

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Pensions auto-enrolment is an undoubted policy success, save for one unintended consequence – it is producing a torrent of new small deferred pots that no longer receive contributions. Deferred pots in the master trust market are projected to grow to around 27 million by 2035 if no changes are made to address the problem.

In the recent Autumn Statement, the Chancellor announced a call for evidence on a lifetime provider model. This would help individuals to move towards having one pension pot for life, thereby helping to tackle the long-standing problem of "small pot" pensions.

This briefing details a "member choice" proposal, whereby members of workplace pension schemes would be given the right to choose the pension scheme (and provider) into which their employee and employer contributions are paid. Essentially, the exercise of member choice would become a major mechanism for achieving a pot for life.

SUMMARY

- The DWP proposal to establish multiple consolidators to help reduce the existing stock of small deferred pension pots is welcomed. Meanwhile, over one million new sub-£1,000 pots are being created every year, fuelled by automatic enrolment.
- To help arrest this flow, this paper proposes that members of workplace pension schemes should be given the right to choose an alternative destination for both their own, and their employer's, pension contributions; "member choice".
- A change of employer would then be less likely to spawn a new pot; employees would naturally continue to use their chosen pot.
- Crucially, any potential destination pot should be required to meet automatic enrolment's qualifying scheme criteria, notably in respect of minimum contributions, member protections, and access to a charge-capped default investment option.
- A phased implementation is envisaged.
    - Initially, individuals would be given the right to choose where their contributions are paid to.
    - Subsequently, individuals' right to choose could become the default (i.e. automatic) route.

MINISTERIAL FOREWORD

The introduction of Automatic Enrolment in 2012 has brought the biggest change to private pensions in a generation. And with over 20m employees now saving into a workplace pension, with an additional near £30 billion saved in real terms in 2022 compared to 2012 – it is widely agreed that Automatic Enrolment has been a great success. However, as a result of bringing more people into workplace pension saving this has resulted in individuals having multiple pots, with a new pot increasingly created each time an employee changes job.

Multiple pots create barriers for members, making it more difficult for them to engage with their pension, while also making it more challenging for them to maximise their savings and make effective decisions for their retirement. Alongside this, many of these pots are likely to be low in value presenting challenges to the pension schemes who have to administer them – often at a loss, which we estimate currently results in losses of up to £225m per year.

Recently, the Government set out its solution in the consultation *'Ending the proliferation of deferred small pots'*, where we have been clear that we will take action to address this challenge by introducing a small number of authorised schemes to act as consolidators for eligible deferred small pots. Implementation of this approach remains my priority, ensuring that we are able to deal with the current stock of deferred small pots given this represents a cost savers are bearing today.

However, this approach will not completely eradicate the issue – given it will not prevent the flow of future multiple pots from being created. That is why alongside the consultation response, I launched an open Call for Evidence looking to understand the potential benefits of a longer-term vision of a simpler system of workplace pension saving where individuals do not create a new pot each time they change employment.

The Social Market Foundation's report provides an interesting perspective on the benefits of member choice and a single pot for life approach. I would encourage all of industry to engage in this discussion and respond to the DWP's Call for Evidence on the matter – to help inform the development of a longer-term pensions policy. My objective will be to ensure that the interest of savers and their outcomes in retirement remains at the heart of our decisions.

Paul Maynard MP

Parliamentary Under Secretary of State at the Department for Work and Pensions

FOREWORD

Over a decade ago when I was the inaugural Chair of the National Employment Savings Trust opening for business in 2012, there were two large policy issues which everyone knew would inevitably have to be addressed at some stage. The first was how does inertia (on which Automatic Enrolment depended) transform into Engagement (required for the complexity of the At Retirement decisions). The second was how should the UK address the inevitable millions of Small Pots which would arise (as they had in Australia) as workers changed jobs. DWP analysis suggested it was not unusual for workers to have eleven jobs in their working lives.

Underlying the Small Pots issue there was a fundamental tension – how should a pension system dependent on harnessing the collective agency of the Employer evolve to give individual members control of their pension pots.

This Policy paper sets out a solution which begins with the end in mind – empowerment of the individual to direct their own contributions to the provider of their choice (as has already happened in Australia) and sets out how it can be overlaid onto an occupational pension system.

November's Autumn Statement was in my view right to focus on the future situation for pension savers rather than just looking back at the considerations prevalent a decade ago. Auto enrolment has been an outstanding success and deserves to evolve rather than be held hostage to historic thinking.

I commend Michael and Tom for thinking through the various issues to be addressed and I hope that the brightest and best in the industry will take up the challenge and respond to the Government's Call for Evidence to help develop this policy into a future reality.

Lawrence Churchill CBE

INTRODUCTION

The automatic enrolment of employees into workplace pension schemes is widely regarded as a policy success, with one major caveat; it is producing a Niagara of small deferred pension pots (i.e. no longer receiving contributions). Today there are roughly 20 million deferred pots containing less than £10,000, and 12 million of these hold less than £1,000.[1] Deferred pots in the master trust market are projected to grow to around 27 million by 2035 if no changes are made.

In addition, within each year's new cohort of small pots is a sizeable number that we know will get forgotten about. Over 2.8 million pots are considered lost (some 9% of all pots), an increase of 75% over the last four years.[2] Estimated to contain £27 billion of assets, they hold nearly 5% of total uncrystallised DC pot assets.[3]

Many people have multiple pots, thereby missing out on economies of scale and, in addition, small pots are expensive to administer (relative to their size); in respect of sub-£1,000 pots, the industry's net loss is estimated to be up to £225 million per year.[4] The consequences are smaller retirement incomes than otherwise, and a less efficient and profitable industry.

THE DEPARTMENT FOR WORK AND PENSIONS' PROPOSAL

Consolidation

The recent Autumn Statement confirmed the Government's intention to implement a Department for Work and Pensions' (DWP) proposal that deferred pots should be automatically transferred into one of a number of default consolidators. This would be selected from today's arena of automatic enrolment's (AE) authorised scheme providers[5], with the pot size eligible for consolidation capped at £1,000. However, the DWP's proposal also indicated an intention "*to review this at regular intervals, increasing the value as appropriate, to ensure the limit is not reducing the effectiveness of the default consolidator approach*".

Given that the purpose of consolidation is to create fewer, larger pots, the logical policy destination is ultimately a system where individuals have a single pot at one provider, for life.

The word "default"; scope for confusion

The DWP's proposal prefaces "consolidator approach" with the word "default", but it is not clear to what this refers to. One application in current pensions law is the requirement that, to qualify for automatic enrolment, a workplace pension scheme must have a default investment option in place (with a cap on charges).[i]

That aside, the DWP probably intends that small deferred pots should be *automatically* transferred to a consolidator, i.e. by default, so transfers would not require any action by pot owners. If so, then given the DWP's proposal for *multiple* consolidators, a decision mechanism would be required to determine which consolidator were to receive which pot. The DWP refers to a carousel approach[6], but this would require both a database and a clearing house to ensure that small pots are transferred to the correct owner in the correct consolidator. The scope for confusion is widened when an owner already has other pots in more than one consolidator.

Further complexity concerns pot assets; should they be sold for cash prior to pot transfer (if so, who would subsequently decide how the cash were invested[ii]?), or should they be transferred *in specie*? Perhaps the DWP's use of "default" is also a reference to transferred small pots being automatically invested into a default fund.

Market impact

By the DWP's own admission, it faces some implementation challenges, potentially fuelled by a lack of industry cooperation. The DWP has said that it does not want to disrupt the provider market, but it is hard to envisage how it could avoid doing so given:

- the high concentration of small pots amongst only five master trust providers, which hold some 75% (15.3 million) of the deferred pots worth less than £10,000;
- the DWP's objective to minimise the number of (operationally expensive) transfers required to achieve the largest reduction in pot numbers; and
- the higher the number of consolidators, the higher the administrative burden on non-consolidator schemes ceding pots to them.

[i] Employees therefore do not need to make any active choices in order to save for their retirement. Instead, an investment vehicle is automatically selected, unless the individual actively opts for an alternative fund. The second use of "default arrangement" is where individuals do not choose their investments (whether in a qualifying AE or not), which are subject to the defined contribution (DC) governance requirements to have a default strategy, etc.

[ii] In practice, likely to be the receiving trusts overseeing consolidators operating default liquid investment strategies, with daily dealing.

The logical conclusion is that there will be relatively few consolidators.

Consolidator selection; an existential threat to some providers?

The five providers holding most of the small deferred pots are likely to become consolidators because transfers would not be required in respect of some of the pots that they already hold. But it is much less clear how many of the other 16 commercial defined contribution (DC) master trusts would apply for, and receive authorisation from, The Pensions Regulator (TPR).[iii] Those who miss out on consolidator status risk a reduction in income as they see some of their assets under management (AUM) gravitate to the (relatively few) authorised consolidators. In addition, they may find it more difficult to attract new clients through the state-sponsored door that is automatic enrolment (the most cost-effective way of increasing AUM).

Consolidation: shortcomings

(a) The consolidators will not help abate the flow of small pots

Consolidation is concerned with addressing the existing stock of small pots, but every year over one million new sub-£1,000 pots are created. This is primed to accelerate with the recent passing of the Pensions Extension of Automatic Enrolment Act, which reduces the age for automatic enrolment from 22 years to 18 years of age.

(b) The number of lost pots will continue to rise

There is a pool of future lost deferred pots within the ongoing flow of new active pots; default consolidation will do little to diminish it (and the lost pots in the stock of deferred pots will remain lost).

(c) Contract-based schemes: missing out?

Master trusts represent 89% of all active memberships in DC schemes, the other 11% being with contract-based (predominately non-workplace scheme) providers[iv]. Given the latter's relatively minor presence in the market, those without authorised master trusts are unlikely to become consolidators; consequently, some of the self-employed, for example, will potentially fall outside of the consolidators' domain.

[iii] Go Pensions' *2023 DC Master Trust league table (January 2023)* lists 21 master trusts that are available to all employers as a commercial proposition. TPR lists a total of 36 authorised DC master trusts (as at end-2022), but this includes industry-specific master trusts which are only open to certain groups of employers.

[iv] There are some contract-based workplace schemes, notably Group Personal Pensions schemes (GPPs)

(d) Inertia reinforced

The current workplace pensions system encourages inertia, as does the DWP's proposed consolidation approach; everything is done for the employee. Inertia can be harnessed positively (automatic enrolment!) but there are also adverse consequences, notably the widespread lack of engagement with workplace pensions.

PROPOSAL

Introduce member choice to stimulate engagement

It is proposed that members of workplace pension schemes should be given the right to choose the pension scheme (and provider) into which their employee and employer contributions are paid.

Potential pensions schemes eligible to participate in member choice (and receive contributions) could include commercial master trusts, life companies, and other providers of group personal pensions (GPPs) and group self-invested personal pensions (SIPPs).[v]

Some individual pension pots could also be potential member choice recipients, subject to:

- the receiving provider having agreements in place under which the employer and employee meet AE's minimum contributions requirements;
- contributions being paid via payroll (which imposes contribution monitoring obligations upon the provider); and
- the default investment being subject to the Financial Conduct Authority (FCA) charge cap for auto-enrolled contract and trust-based pension schemes.

Note that, subject to employer approval[vi], auto-enrolled contributions can already be paid into a non-qualifying personal pension, or even a non-pension product, chosen by the employee. The employee would need to opt out of the employer's AE qualifying scheme, and the employer would still need to automatically re-enrol the employee every three years.

[v] Note that in respect of employers making payroll contributions into a personal pension scheme for two or more workers, then it would be under the remit of an Independent Governance Committee or a Governance Advisory Arrangement.

[vi] The employer would have to be sure that TPR did not consider that the employee was being induced to give up membership of a qualifying pension scheme.

Protections and standards: no watering down

The destination pots of employees who exercise choice, but who do not choose their own investments, should benefit from the same protections as the pots of auto-enrolled members of workplace pension schemes. In addition, they should continue to benefit from the same employer duties and safeguards.[vii]

Furthermore, financial services firms offering eligible destination pots should be required to comply with the FCA's Consumer Duty, a recently introduced higher standard of consumer protection. This encompasses the management of long term investments found within pension products.[viii]

Operationally, the exercise of member choice should not be permitted to inhibit employers' ability to perform their Employer Duties, and meet the employer safeguards (in place to protect the rights of individuals), as specified in the automatic enrolment legislation.

In the meantime, the DWP could introduce a simple nudge; P45s should include employees' most recent active workplace savings pot. This should help encourage those moving jobs to ask their new employer to pay contributions to the last active pot (which would otherwise become deferred, then potentially forgotten about, and ultimately lost).

A BACs-style clearing house to avoid an additional employer burden

There is currently no infrastructure in place that could receive a single (bulk) monthly payment from an employer, and then divide it up for onward distribution to multiple individuals' pots.

It is important that the exercise of member choice does not create a significant additional burden for payroll operations. A BACs-style clearing house could facilitate payroll contributions, and it could also serve to confirm to employers that their contributions were destined for qualifying schemes (evidencing that they were satisfying their auto-enrolment obligations). Pension providers would assume contribution monitoring obligations; any necessary communication with employers could be via the clearing house.

[vii] These requirements are triggered by receiving payroll contributions or agreeing that the pension is a qualifying scheme, rather than conditions which need to be met before payroll contributions can be received.

[viii] The three elements of the FCA's Consumer Duty require firms to take all reasonable steps to (i) avoid causing foreseeable harm to customers; (ii) enable customers to pursue their financial objectives, and (iii) act in good faith.

The DWP has already identified the need for a clearing house to facilitate pot consolidation; the same infrastructure could facilitate the exercise of member choice (perhaps developed in tandem with the ongoing dashboard project). A clearing house could, in time, act as a multi-faceted vehicle to connect pension schemes; enable individuals to identify, view and consolidate their pensions; and facilitate widespread engagement in, and ownership of, pension pots.

MEMBER CHOICE: THE BENEFITS

Reinforcing auto-enrolment through personalisation

It is striking how many people talk about "my ISA" and "my SIPP", but depersonalise their membership of pension schemes facilitated by their employer. Inevitably, people do not feel in control of their workplace savings when they are compelled to accept having their savings invested in an arrangement not of their choosing.[ix]

Workplace-derived savings should be considered as an extension of private provision; they should be as portable and as personal as a bank account. Accounts should bear the name of the individual to engender a sense of ownership; being in control is closely allied to being motivated. The exercise of member choice requires, and encourages, decision-making, thereby driving engagement with the pension system.

Better value for money

Today, the workplace DC market is focused on the employer as the "buyer" of DC pension services; the individual employee is essentially invisible. Consequently, the market usually views value through an employer lens, prioritising lower costs over improved saver outcomes.

If significant numbers of employees were to exercise member choice, the competitive landscape for workplace-derived pension contributions could be transformed. Individuals, rather than corporate HR departments, would finally be acknowledged as the customer, and traditional workplace pensions providers would have to adopt a more retail focus to gain (and retain) new business (partly through a forensic examination of fund management fees). Saver outcomes should subsequently improve.

[ix] An extraordinary 39% of auto-enrolled scheme members are unaware that they are a member of a workplace pension scheme; 95% have never tried to change their fund; 91% do not know where their funds were invested; 80% do not know how much is in their pension pot; and 34% do not know who their pension provider is. And very few have identified a beneficiary, should they die. *Decision Technology survey, 2017*. Response of 938 auto-enrolled scheme members.

A role for all qualifying scheme providers

The introduction of member choice would create an opportunity for those qualifying scheme providers who are likely to miss out on small pot consolidator status; many would be keen to act as "pot for life" providers. With an alternative role, some of the provider opposition to consolidation would wane, greatly helping in the implementation of the DWP's proposal for default consolidators.

Far fewer small pots, faster

The introduction of member choice is intended to complement the DWP's proposal for multiple default consolidators. With consolidation focused on reducing the stock of small pots, and member choice materially arresting the ongoing flow, the DWP would achieve its objective of culling the small pots' population far more quickly than without member choice. In addition, with fewer new small pots being created, the number that subsequently become lost would be significantly reduced.

Fewer transfers

Member choice will slow the production rate of future deferred small pots. Consequently the number of transfers required in the consolidation process would be reduced, reducing operational risk, and saving the industry time and money.

Larger pots at retirement

The introduction of member choice is intended to stimulate the accumulation of savings, as well as helping to arrest the creation of small pots. Bigger pots at retirement will produce larger retirement incomes, be they taken through annuities or drawdown, but member choice is not a decumulation phase retirement solution.

LEGAL OVERVIEW

Phased implementation

The introduction of member choice could be implemented in two stages. First, individuals could be given the right to choose where their contributions are paid by their current employer, subject to the receiving pots being afforded the aforementioned protections. Subsequently, individuals' chosen provider could become their default (i.e. automatic) arrangement.

Stage 1: The right to choose. No new Pensions Act required

The introduction of member choice could be introduced by regulations rather than through a new Pensions Act because the exercise of member choice could be conducted within auto-enrolment's legal architecture.[x] A few amendments to existing regulations would suffice, to:

- give engaged employees the right to choose the destination of their pension contributions[xi];
- confirm that employees who exercised choice would (still) be deemed to be meeting the requirements for active membership of their employer's scheme; and
- ensure that employees continued to benefit from "default arrangements",[xii] including access to a charge-capped default investment option (a qualifying scheme requirement).[7] However, if the member were to choose his own investments, then charge cap protection would fall out of the scope of default arrangements.

Employers would be obliged to (continue to) make "prescribed arrangements" for those employees who exercised choice, as per the auto-enrolment legislation, including the provision of "enrolment information". They would still be able to exercise postponement periods (in respect of new employees), and would need to exercise re-enrolment every three years (should an individual opt out of AE contributions altogether, or cease to contribute to their "member choice" scheme). In addition, members exercising choice should be able to continue to benefit from any available salary sacrifice arrangements.

Alongside the changes to the existing regulations, enabling legislation would be required to give the Secretary of State the power to place new obligations on employers to require them to implement an individual's choice. The relevant legislation could be introduced by way of a Private Members Bill similar in form to The Pensions (Extension of Automatic Enrolment) Act 2023 which received Royal Assent on 18 September 2023.

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[x] The main building blocks of the auto-enrolment regime are the Pensions Act 2008, Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010, Employers' Duties (Implementation) Regulations 2010 and Employers' Duties (Registration and Compliance) Regulations 2010.

[xi] Regulation 6 of the Auto-Enrolment Regulations 2010 (SI2010/772) would have to be amended to oblige employers to pay their pension contributions to a pot of the employee's choosing, rather than being automatically enrolled into the employer's default pension scheme. Sections 3 and 143 of Pensions Act 2008 does give the DWP the power to use a Statutory Instrument (SI) to amend regulation 6. As regulations have already been made, the SI could be made using the negative procedure.

[xii] *FCA Handbook*; "default arrangement" is an arrangement expressly provided by an operator of a qualifying scheme for the purpose of investing the workplace pension contributions of employees who have expressed no choice in relation to the investment of such contributions.

Stage 2: Member choice as the default; primary legislation

Currently, members join their employer's scheme automatically, i.e. by default. Member choice is intended to allow engaged members to request that contributions are sent to a different qualifying scheme. A more substantial and impactful development would be for member choice to be made the default, so that where an individual changes jobs their new employer is required to automatically enrol them into their chosen scheme, without the individual needing to take any action. This would require structural change to today's auto-enrolment architecture, effected through primary legislation.

THE OBVIOUS DESTINATION: A "POT FOR LIFE"

Over time, pot consolidation could culminate in individuals having a single "pot for life", consistent with the pension minister's references to the compelling logic for a "pot for life" and a "lifetime provider model":[8]

> *In the longer-term, a simpler system of workplace pension saving could emerge to deal with the fundamental issue that new pension pots are created each time someone starts a new job, for example, a lifetime provider model with each saver stapled to a 'pot for life'…*

Personal pension pots currently fall outside of auto-enrolment's qualifying scheme framework. However, new FCA rules, soon to come into effect, will require non-workplace pension schemes to offer a default investment option to non-advised customers.[9] Personal SIPPs, for example, could then be "pot for life" candidates.

There is no consumer rationale to divide DC retirement savings into separate workplace and non-workplace pots; combining them would be the purest form of pot consolidation, probably accompanied by the merger, under a single regulator, of today's trust- and contract-based regulatory frameworks.

CONCLUSION

The introduction of member choice would be an enhancement to, and natural evolution of, the auto-enrolment regime. It would provide a rare policy "win-win-win". Not only would it accelerate the reduction in the number of small deferred pots, and therefore the number of future transfers and lost pots, but it would present employees with an opportunity to exercise greater control over their workplace-derived savings. This would set in train a mechanism to encourage more people to engage with their retirement savings, which would incentivise providers to treat them as individuals rather than anonymous members of workplace schemes. In addition, it would provide the DWP with a way to appease those providers who are likely to miss out on consolidator status.

Member choice would also represent a significant stepping stone towards a single (pensions) pot for life, facilitated by common sense and digital capability. Simplicity to the fore.

ABOUT THE AUTHORS

Michael Johnson

Michael Johnson has written some 40 think tank policy papers, predominately concerning pensions, after a career in investment banking. Some of his proposals have been implemented, including the introduction of the Junior and Lifetime ISAs. He was an early advocate of pensions freedoms, accompanied by default Auto-Protection at 60 (yet to be implemented).

Tom McPhail

Tom McPhail is Director of Public Affairs at the Lang Cat, providing financial services firms with strategic advice on policy issues and PR. In 2021 he conducted an external review of the Money and Pensions Service on behalf of the DWP, and prior to that was Head of Policy and lead pensions spokesman for Hargreaves Lansdown.

ENDNOTES

[1] DWP; *Ending the proliferation of deferred small pots, Table 2, July 2023.*

[2] The Pensions Policy Institute; *Briefing Note 134: Lost Pensions; what's the scale and impact? 2022*.

[3] *Ibid, Table 2.*

[4] *Ibid, para. 76*.

[5] *Ibid*.

[6] *Ibid, clause 30.*

[7] See Regulation 3 of the Charges and Governance Regulations 2015.

[8] *Ibid*. Ministerial Foreword.

[9] Effective from 1 December 2023. See FCA; *PS22/15: Improving outcomes in non-workplace pensions*.